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2021 Q3 Market Report

South Coast Commercial Real Estate

A DIVERGENCE BETWEEN SALES AND LEASING

The South Coast commercial markets started the year slowly in Q1 and then kicked into a high gear in Q2 amidst the roll-out of widespread vaccinations and “reopening” of the economy. Then, in Q3 the sales and leasing markets diverged, with sales maintaining a growth trajectory and producing the largest quarterly volume of the year, while in contrast, leasing activity slowed dramatically. In fact, Q3 leases generated the lowest quarterly gross absorption since the financial crisis in 2008.

Here are some summary highlights:

- During Q3, the number of properties for sale decreased 20%, which trimmed inventory back to its lowest level since 2019.
- Year-to-date commercial sales dollar volume (excluding hotels) is up 48% compared to 2020, with most of the activity in Q2 and Q3.
- More importantly, sales dollar volume is only 2% below the pre-COVID 5-year average. By contrast, year-to-date total lease consideration is down 30% from the pre-COVID 5-year average.
- Whereas Q2 produced 100 lease transactions (the highest quarterly count in 5 years) Q3 produced just 49 transactions, 30% below the 5-year average.
- Mirroring the national trend, the South Coast’s industrial sector has seen stronger sales and leasing than office or retail property. Industrial space available for lease has decreased 53% year-to-date, while industrial sales have generated more than $60 million in volume.

COMMERCIAL SALES – A Complete Recovery?

After a slow start in Q1, commercial sales transactions have gained steam as the year progressed, culminating in 34 sales in Q3 alone, the largest quarterly total since 2012. Year-to-date dollar volume (excluding hotels) is about even with the pre-COVID 5-year average, while transactions are up 7%. In addition, the inventory of properties for sale has contracted back to pre-pandemic levels. Based on these benchmarks, the level of demand we are seeing, and deals under contract, all indications are that the sales market has recovered from the economic slowdown caused by the pandemic. The one caveat to consider is that most leasing submarkets are still in a phase of recovery, which could over time create an undertow in sales pricing and activity.

The largest sale to date was Bill Foley’s Q3 purchase of the 121-key Hotel Californian for an estimated price of $130 million. It was the first major hospitality acquisition on the South Coast since 2018 and represents a prominent vote of confidence in both Santa Barbara tourism and the waterfront trade area. Also in Q3, the 87-key Pacifica Suites hotel at 5490 Hollister Ave in Goleta traded for $27.5 million.

The Hotel Californian at 36 State St was purchased by Bill Foley, Chair man of Fidelity National Financial and founder of Foley Wines.

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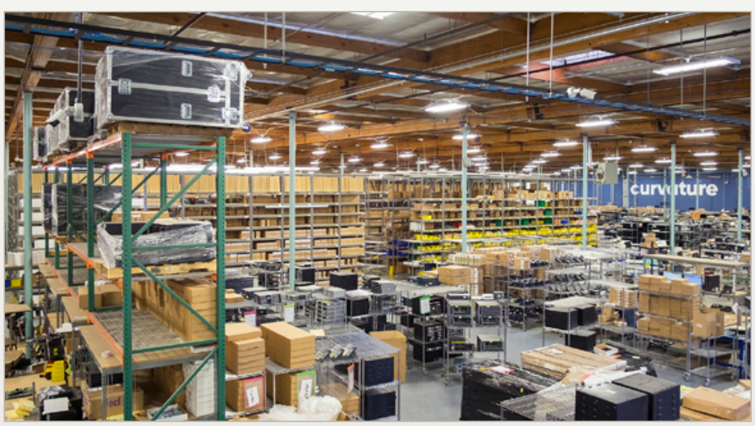
In addition to these hospitality sales, industrial sales have been especially robust year-to-date, generating more than double the transactions and dollar volume compared to 5-year averages. Among the deals completed in Q3, the 32,133 sf industrial/office building at 126 E Haley St in Santa Barbara was purchased by an investor for $13.9 million. The Foodbank of Santa Barbara County purchased 80-82 Coromar Dr, a 77,900 sf industrial/office property in Goleta, for $12.7 million. Five industrial condos at 116 N Nopal St in Santa Barbara came to market in June and were snatched up by multiple buyers for a combined $2.9 million. The phenomenon of wealthy individuals buying small industrial properties for personal storage and/or hobby space—rather than commercial use—is gradually becoming a trend and represents another vector of demand for scarce industrial space on the South Coast. The average price paid for industrial property this year is $495 per sf, which for comparison is more than double the average price in the Los Angeles industrial market.

In contrast to industrial, Q3 proved to be a slow quarter for office and retail sales, which are lagging 32% and 20% below the 5-year averages so far in 2021. The two largest office sales in Q3 were completed by owner-users. Westmont College acquired 29 W Anapamu St in Q3 for $7.2 million, a 18,776 sf office building across the street from another building owned by Westmont. Also in downtown Santa Barbara, the civil engineering firm Flowers and Associates purchased 115 W Canon Perdido St for $4.7 million. For retail, the quarter's most notable sale was 209 Anacapa St, which fetched $887 per square foot, thanks in large part to its generous on-site parking in the parking-challenged Funk Zone.



The Foodbank of Santa Barbara County purchased 80-82 Coromar Dr in Goleta for $12.7M, the largest owner-user purchase year-to-date.

Owner-user buyers were not active in Q1 but have surged into the market since then, producing 57% of sales transactions in Q2 and Q3, including the purchases by Foodbank, Westmont, and Flowers and Associates mentioned above. Owner-users have represented 36% of dollar volume to date (excluding hotels), a much higher percentage than we typically see.

Off-market sales have been less pronounced this year, decreasing from 56% of transactions in 2020 to 38% of transactions to date in 2021. After reaching a peak of 82 properties for sale at midyear, there were 24 on-market sales in Q3, which contributed to a 20% contraction of inventory over the course of three months.

Prices did not decrease much during the pandemic slowdown and appear to have rebounded to pre-2020 levels, if not higher. Looking ahead, demand among high-net-worth investors and private equity teams remains strong, as they seek to capitalize on low interest rates. In fact, several large investment properties currently under contract are scheduled to close in Q4. In addition, owner-user requirements are abundant in the market. Will there continue to be supply to satisfy the demand? As long as prices hold up, owners willing to sell can be found.

OFFICE LEASING

Following heavy leasing activity in Q2, South Coast office deal flow throttled down in Q3, producing only 27 lease transactions totaling 81,000 sf. It is probably not a coincidence that during this period the delta variant of COVID curtailed, postponed, or otherwise complicated the return to the office for many businesses and organizations. Vacancy reached a record low just prior to the pandemic, and since then available office space has expanded by 41%. Most of that added inventory has emerged in Santa Barbara.

Santa Barbara

Santa Barbara's office market has become a bit mystifying. On the one hand there is record-high vacancy and general uncertainty about future demand for office space. On the

200 E Carrillo St is fully leased with three leases signed in 2021, including most recently a ground-floor suite by Hollister & Brace.

other hand, achieved rents are 15% higher than five years ago when vacancy was half what it is today, and leasing volume is even with pre-pandemic levels. Unprecedented market conditions, which would presumably disrupt leasing behavior, don't appear to be impacting deals getting signed.

Having said that, Q3 was one of the slowest leasing quarters in memory with gross absorption of just 28,000 sf. A 3,661 sf ground-floor suite at 200 E Carrillo St was leased by Hollister & Brace. Besides that, there were 15 other leases of 2,500 sf or less. However, even with the dip in activity during Q3, year-to-date transaction volume and gross absorption are on par with pre-COVID levels.

Santa Barbara's vacancy finished Q3 at 9.6%, a conspicuously elevated rate but a slight decrease from the record high of 10.8% at midyear. The reduction of available space during Q3 was largely due to property withdrawn from the market, rather than a flurry of leasing. Two buildings that had been for sale or lease—111 E Victoria St and 12-14 E Carrillo St—are no longer for lease, which pulled 37,000 sf from the market.

Rents have also proven surprisingly resilient. Achieved lease rates so far in 2021 are level with the record-high average from 2019, and have rebounded approximately 5% from the 2020 average. Average asking rent is also at a historic high. In general, it appears landlords are unfazed by the current glut of vacancy and possible weakening of demand due to the pandemic.

Looking ahead, the lull of activity in Q3 does not appear to be carrying forward, based on deals expected to be signed in Q4 and current requirements in the market.

Goleta

In Goleta, the leasing crescendo of 2018-2019 that produced 1.25 million sf of gross absorption has eased back to more typical volume during the pandemic. Year-to-date transactions and absorption are 18% and 8% below the prior 5-year averages, bearing in mind that two of the prior five years were record high years.

After reaching a historic low of 4.6% right before the pandemic, Goleta's vacancy rate has increased to 5.8% in Q3, which still represents a relatively low rate, historically. The two largest available spaces are 38,100 sf vacated by Inogen at 326 Bollay Dr and the 31,500 sf Asylum Research space at 6310 Hollister Ave.

Pure office buildings—as opposed to flex office/R&D buildings—in Goleta have seen a rise in vacancy since COVID emerged, as many tenants have made moves to reduce their footprint. 5425 Hollister Ave was fully leased before the pandemic but now has 27,000 sf of vacancy after Cottage Health vacated and CIO Solutions "right-sized" to half its previous space in the building. Next door at 5383 Hollister Ave, Agilisys also gave up about half of their space in the building. At 420 S Fairview Ave, Sientra is now offering 20,200 sf for sublease, and Texas Instruments has 13,000 sf for sublease at 6750 Navigator

UCLA Health leased 6,307 sf at 5383 Hollister Ave, while Agilisys right-sized to a smaller suite.

Way. By comparison, blended office/R&D buildings have not seen much pandemic-related vacancy.

Leasing activity in Q3 was limited. Among the more notable deals, Scalable Commerce leased 8,027 sf at 110 Castilian Dr, and two leases were inked at 5383 Hollister Ave: UCLA Health leased 6,307 sf and Bermant Development leased 3,031 sf.

Similar to the Santa Barbara submarket, the average achieved rent in Goleta through three quarters of 2021 is at a historic high of $2.10 gross psf. Suburban business parks—which make up most of Goleta's office buildings—are in high demand nationally, as the pandemic has induced many companies to consider moving from urban offices to less dense settings. With this backdrop, tenants will continue to look favorably on Goleta.

Carpinteria

With nine office transactions completed to date, Carpinteria has already produced more leases this year than the previous two years combined. However, most of the leased spaces were small; gross absorption is down 33% compared to the pre-COVID 5-year average, even though transactions are up 45%.

There were three leases during Q3, including 4,770 sf at 1180 Eugenia Pl leased by Coastal Blooms and 4,029 sf secured by MFG Management at 4180 Via Real. The vacancy rate has continued to decrease, now at 2.5%. There are just four spaces available, all of which have been on the market for more than a year.

The entitled 8.6 acres at 6380 Via Real is under contract to close in Q4. Assuming it goes through, the buyer is expected to proceed with construction of an approved 80,242 sf office building for 2023 delivery.

RETAIL LEASING

The South Coast has seen a resurgence of retail leases following a substantial slowdown in 2020. Transactions increased 90% year-over-year and are even with the pre-COVID 5-year average. However, there have been few leases of larger space, and the average lease size is just over 2,000 sf, the smallest we have ever documented. Consequently, gross absorption of space is down 5% year-over-year and 41% below the pre-pandemic 5-year average.

Santa Barbara continues to contend with high vacancy in its malls and bigger boxes, including the Sears building at 3845 State St, the Ortega Building at 701 State St, and the former Staples building at 410 State St. More than 80% of the available space is in locations we classify as "destination" retail as distinct from "daily needs" retail. This comports with national trends, which show grocery-anchored and other daily needs properties outperforming malls.

Santa Barbara's most renowned destination retail area is the downtown State Street corridor, where storefront vacancy for the 400 to 1300 blocks is 12.8%, after four consecutive quarters of contraction since hitting a record high of 18% a year ago. Along the five central blocks from Cota to Carrillo, storefront vacancy is 20%, double the rate from five years ago.

There have been seven leases on State Street year to date, with all but one being local or regional tenants. The lone exception was the Q3 lease of 6,148 sf at 733 State St by Athleta. With approximately 200 stores in North America, Athleta is a strong lifestyle brand and the first national soft goods retailer to lease a space on State Street in several years. The other Q3 lease of note on the corridor was the former Closet space at 920 State St, leased by a local sports apparel concept called 805 University.

The former Miniso and American Apparel space at 733 State St was leased by Athleta.

Just off State Street, Hook & Press Donuts has settled into the former Jeannine's space at 15 E Figueroa St. In the Funk Zone, a brewery concept leased the 4,700 sf building at 102 E Yanonali St, and Municipal Winemakers renewed at 22 Anacapa St.

Goleta's retail vacancy rate has been remarkably consistent, ranging from 2.2% to 2.7% over the past five years. There were two significant leases at Calle Real Center in Q3: the 6,200 sf former Outback Steakhouse space at 5652 Calle Real was leased to an unnamed restaurant tenant, and the 5,087 sf former Denny's at 5677 Calle Real was leased to Coast Supply. With these leases, vacancy at Calle Real Center is down to 6%, the lowest it's been in many years. Meanwhile, across town the Albertson's-anchored Plaza Shopping Center adjacent to Camino Real Marketplace has been struggling to fill vacancies during most of the past decade. Currently, it has an anchor space and five smaller units available totaling 27,900 sf. The landlord is planning to give the buildings and the parking lot a facelift to attract new tenants. On the positive side, there have been three leases signed there in 2021, including IHOP taking the endcap space facing Hollister Avenue.

INDUSTRIAL LEASING

Goleta entered a cycle of higher industrial vacancy starting in 2017 as spaces relinquished by Channel Technologies, Skate One, Curvature, and Logmein eventually pushed vacancy to a peak of 7.0% in Q1 2020. These vacancies have mostly been backfilled, and leasing has been active during the pandemic, with gross absorption trending 15% higher than the pre-COVID 5-year average. Currently, vacancy is down to 2.9%.

There are three industrial/flex buildings totaling 80,000 sf under construction by RAF Pacifica Group at 6759-6789 Navigator way in Cabrillo Business Park. In Q3, Montecito Bank & Trust leased 9,615 sf in one of the buildings, and negotiations with another tenant are pending to lease the balance of the project. The other Q3 deal of note was 20,823 sf at 26 Castilian Dr leased by DRS Sustainment Systems. Rental rates have held steady through the recent period of higher vacancy and through the pandemic. All signs indicate that the Goleta industrial market is poised for a period of strong demand and low vacancy.

In Santa Barbara, transactions nearly came to a halt in Q3 amid very limited inventory with an industrial vacancy rate of 0.7%. There are only five listings on the market, the largest of which is the 24,291 sf building at 4179-4183 State St. There was only one transaction in Q3, a renewal by Santa Barbara Smokehouse of 2,500 sf at 802 E Yanonali St. Nevertheless, thanks to relatively brisk leasing in the first half of the year, year-to-date gross absorption is 29% ahead of the pre-COVID 5-year average.

Carpinteria's vacancy rate dipped below 2% at midyear with a handful of leases in the early months of the year, including the 19,400 sf lease at 1015 Cindy Ln by Dakar. The lone Q3 transaction was ZBE, Inc's renewal of 18,700 sf at 1035 Cindy Ln. Despite the lack of transaction volume in Q3, only one small space came to market, and vacancy remains very tight at 1.85%. The status quo of scarce inventory and limited leasing activity is very likely to persist for the near future.

The defense contractor DRS Sustainment Systems leased 20,823 sf at 26 Castilian Dr in Goleta.

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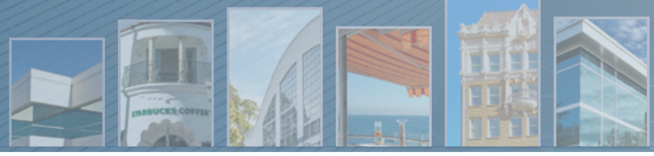

LEASING MARKET DATA

Market	Vacancy Rate		Transactions		Gross Absorption (SF)		Achieved Rent (PSF GR)	
OFFICE								
Santa Barbara	**9.64%**	+15%	**80**	+32%	**232,197**	+2%	**$3.04**	+5%
Goleta	**5.77%**	-11%	**26**	+12%	**229,452**	+13%	**$2.10**	+7%
Carpinteria	**7.45%**	-67%	**9**	+300%	**29,010**	+409%	**$1.86**	-2%
RETAIL								
Santa Barbara	**4.74%**	+25%	**39**	+41%	**75,866**	-1%	**$3.69**	+16%
Goleta	**2.50%**	-1%	**15**	+150%	**36,666**	-3%	**$3.18**	+46%
Carpinteria	**6.65%**	-17%	**2**	-11%	**3,041**	-88%	**$2.14**	-13%
INDUSTRIAL								
Santa Barbara	**0.70%**	-53%	**14**	-2%	**73,887**	+50%	**$1.82**	-14%
Goleta	**2.90%**	-50%	**17**	-24%	**161,347**	+1%	**$1.69**	+9%
Carpinteria	**5.31%**	-65%	**7**	+87%	**78,749**	+284%	**$1.20**	+2%

Change percentages are compared to 2020 values, annualized where appropriate.